<u>Outlook: What the Dollar Means to Frontier Investors. Why Low Correlation is a Good Thing.</u>

"It's all about bucks, kid. The rest is conversation." **Michael Douglas, in "Wall Street"**

One wind at the back of our Frontier markets during Covid has been the behavior of the US dollar. Kyklos is largely a bottom-up investor, and we do not make macro predictions such as a future exchange-rate target. We model macro risk for our countries, however, to identify big-picture major devaluation risks, and our positions often offer natural hedges to exchange-rate risk, such as exporters whose earnings benefit from devaluation. In effect, we have opinions about currencies in order to measure and avoid risk.

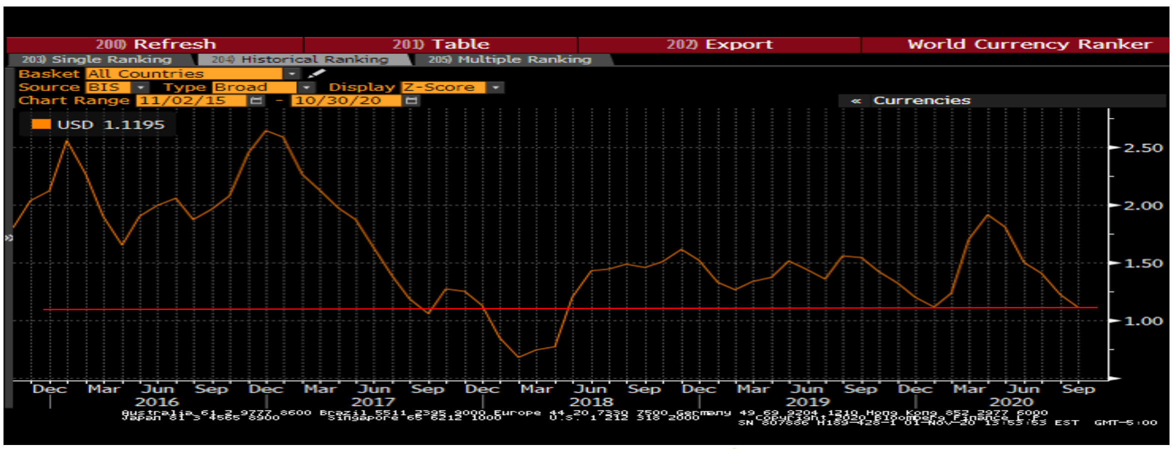
Another, simpler reason we follow currencies is that for Kyklos, as a US-dollar investor, the dollar's strength or weakness is a broad driver of Frontier market performance. A weak dollar magnifies the profits and prices of foreign companies in dollar terms, and therefore the investment returns for dollar-based investors like us. Frontier markets tend to rise when the US dollar falls, and vice-versa, as foreign investors react to the currency (chart below). As the dollar swooned during the crisis, Frontier rallied, but that price relationship is now back to pre-Covid levels. Some of the easy money has been made.

Frontier Markets Zig as the US Dollar Zags. Looks Like Back to Normal?
MSCI Frontier Markets Index (MXFM) versus US Dollar Index (DXY)

Sources: Bloomberg, MSCI

For currency fundamentals, we use Real Effective Exchange Rates (REER) as a rough indicator of valuation. It's not a timing tool, but it does predict long-term currency moves reasonably well.[1] By that measure, the dollar is less overvalued than at almost any point in the past five years. If it strengthens, the natural hedges in our portfolio will come in handy.

The Dollar is a Lot "Cheaper" Than it Used to Be.
US Dollar REER valuation, Z-score



Sources: BIS, Bloomberg

The Beauty of Lower Correlations

Kyklos runs a concentrated portfolio of Frontier market equities. A major reason to invest in the fund is diversification to reduce risk, because our positions overlap very little with most investors' portfolios, and because our correlation to global markets is very low. After all, if an asset moves exactly in line with what you already own, the benefit to you of adding it to your portfolio is zero. Kyklos correlates to Global Developed and Emerging markets overall at a bit more than 50%, on average. During the Covid crisis, our correlation went to abnormally positive levels of nearly 1.0, which is perfect correlation-- an indicator that the babies were being thrown out with the bathwater, irrespective of fundamentals. Happily, our correlation since March has returned to its low historical average level, confirming that most investors stand to lower risk by diversifying into our fund.

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[1] See https://insight.kellogg.northwestern.edu/article/exchange-rates-predictions-real-nominal as an example.

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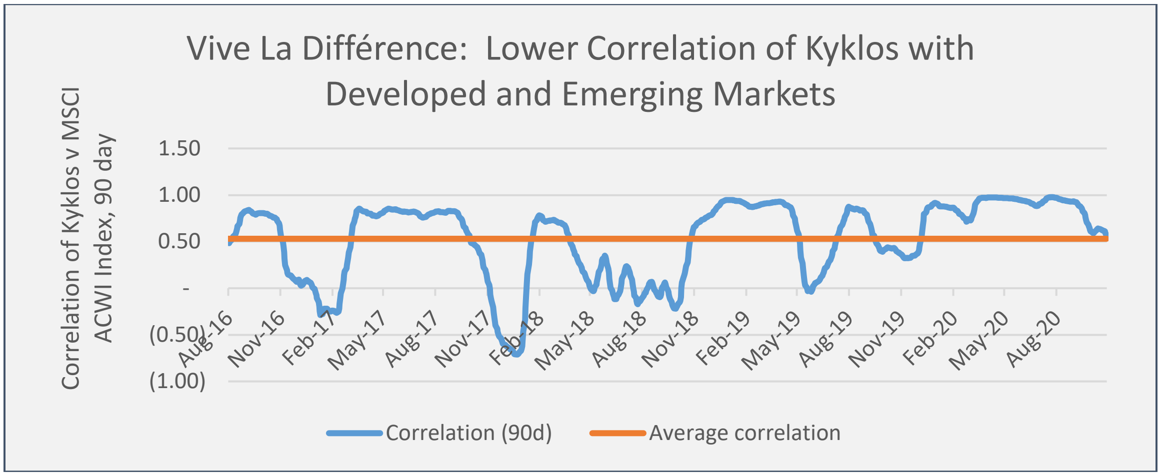

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